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August 25, 1993

BY HAND

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Rate Regulation,
MM Docket No. 93-215

Dear Mr. Caton:

Please find enclosed, on behalf of the National Association of Telecommunications Officers and Advisors, et al., an original and nine copies of the Comments of the National Association of Telecommunications Officers and Advisors, et. al, in the above-referenced proceeding.

Any questions regarding the submission should be referred to the undersigned.

Sincerely,

William E. Cook, Jr.

Enclosures

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	MM Docket No. 93-215
Rate Regulation	

TO: The Commission

COMMENTS OF THE NATIONAL ASSOCIATION OF TELECOMMUNICATIONS OFFICERS AND ADVISORS, THE NATIONAL LEAGUE OF CITIES, THE UNITED STATES CONFERENCE OF MAYORS, AND THE NATIONAL ASSOCIATION OF COUNTIES

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Dated: August 25, 1993

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SUMMARY

Only in extremely limited circumstances should cable operators be permitted to use cost-of-service showings to justify rates above benchmark or capped levels based on costs. It is clear from the legislative history of the Cable Television Consumer Protection and Competition Act of 1992 that Congress did not intend for the Commission to allow cost-of-service showings as a primary method for determining rates.

Cost-of-service showings should be allowed only under extraordinary circumstances, where, due to unique conditions, the cable operator has demonstrated that application of the benchmark and price cap method of rate regulation envisioned by Congress would not ensure the continued economic viability of an efficiently operated cable system. In these circumstances, the operator must show not only that it is unable to recover its costs, but that those costs are justified in light of the unique circumstances present in the system. The determination of whether such costs are justified should be made with reference to costs for other similarly-situated systems.

With regard to the development of allowable costs of multiple system operators ("MSOs"), the Commission should ensure that, where possible, costs are determined on a franchise-by-franchise basis, with costs that are truly company-wide allocated to franchise areas based on each

franchise area's pro rata share of total subscribers served by the MSO. The Commission should establish special rules to deal with costs incurred through transactions with affiliated companies, and should exclude excess acquisition costs from recoverable costs.

With regard to the "streamlining" alternatives to traditional cost-of-service showings proposed by the Commission, Local Governments strongly support the concept of streamlining the rate regulation process and reducing the administrative burdens on the Commission and franchising authorities. However, the Commission should be cautious that any alternatives it considers not undermine the benchmark method. Local Governments believe that the alternative allowing abbreviated cost-of-service showings for significant prospective capital expenditures contains significant pitfalls that renders it unworkable as proposed by the Commission. Similarly, Local Governments feel that other streamlining alternatives proposed by the Commission, such as a method involving the nationwide averaging of costs or special rules for small systems, are not justified and would be counter to the benchmark and price cap regulation already developed by the Commission.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	MM Docket No. 93-215

TO: The Commission

COMMENTS OF THE NATIONAL ASSOCIATION OF TELECOMMUNICATIONS OFFICERS AND ADVISORS, THE NATIONAL LEAGUE OF CITIES, THE UNITED STATES CONFERENCE OF MAYORS, AND THE NATIONAL ASSOCIATION OF COUNTIES

The National Association of Telecommunications Officers and Advisors, the National League of Cities, the United States Conference of Mayors, and the National Association of Counties (collectively, the "Local Governments") submit these Comments in the above-captioned proceeding.

I. INTRODUCTION

On July 16, 1993, the Federal Communications Commission ("Commission") released a Notice of Proposed Rulemaking in this proceeding to solicit comments on regulatory requirements to govern cost-of-service showings

by cable operators.[1] Cost-of-service showings are designed to allow cable operators to attempt to justify rates above benchmark or capped levels based on costs.

It is clear from the legislative history of the Cable Television Consumer Protection and Competition Act of 1992[2] that Congress did not intend for the Commission to allow cost-of-service showings as a method for determining rates. Congress stated:

> The Committee intends that the Commission establish a formula that is not cumbersome for the cable operator to implement nor for the relevant authorities to enforce. The Committee is concerned that several of the terms used in this section are similar to those used in the regulation of telephone common carriers. It is not the Committee's intention to replicate Title II regulation. The Commission should create a formula that is uncomplicated to implement, administer, and enforce, and should avoid creating a cable equivalent of a common carrier "cost allocation manual."

H.R. Rep. No. 102-628, 102d Cong., 2d Sess. 83 (1992) ("House Report") (emphasis added).

Thus, while cost-of-service showings may be necessary in certain extremely limited circumstances, the benchmark/price cap method developed by the Commission in the Report and Order should remain the primary method of

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[1] Notice of Proposed Rulemaking, In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, MM Docket No. 93-215 (released July 16, 1993) ("NPRM").

[2] Pub. L. No. 102-385, 106 Stat. 1460 (1992) ("1992 Act").

determining rates.[3] Cost-of-service showings should be allowed only under extraordinary circumstances, where, due to unique conditions, the cable operator has demonstrated that application of the benchmark and price cap method of rate regulation envisioned by Congress would not ensure the continued economic viability of an efficiently operated cable system. In these circumstances, the operator must show not only that it is unable to recover its costs, but that those costs are justified in light of the unique circumstances present in the system. The determination of whether such costs are justified should be made with reference to costs for other similarly-situated systems.

With regard to the development of allowable costs of multiple system operators ("MSOs"), the Commission should ensure that, where possible, costs are determined on a franchise-by-franchise basis, with costs that are truly company-wide allocated to franchise areas based on each franchise area's pro rata share of total subscribers served by the MSO. The Commission should establish special rules to deal with costs incurred through transactions with affiliated companies, and should exclude excess acquisition costs from recoverable costs.

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[3] Report and Order, In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket No. 92-266 (released May 3, 1993) ("Report and Order").

The Commission has proposed a number of "streamlining" alternatives to traditional cost-of-service showings. Local Governments strongly support the concept of streamlining the rate regulation process and reducing the administrative burdens on the Commission and franchising authorities. Such alternatives are consistent with Congress' desire that the Commission not develop for general use a common-carrier type model of rate regulation. However, the Commission should be cautious that any alternatives it considers not undermine the benchmark method. Local Governments believe that the alternative allowing abbreviated cost-of-service showings for significant prospective capital expenditures contains significant pitfalls that renders it unworkable as proposed by the Commission. Similarly, Local Governments feel that other streamlining alternatives proposed by the Commission, such as a method involving the nationwide averaging of costs or special rules for small systems, are not justified and would be counter to the benchmark and price cap method of regulation already developed by the Commission.

II. DISCUSSION

A. The Benchmark Analysis Is the Primary Mechanism for Rate Regulation.

The Commission in the Report and Order established a comprehensive rate regulation scheme utilizing a system of benchmarks and price caps. This approach carefully

balanced the interests of subscribers and cable operators and was intended to reduce the administrative burdens on all parties involved. Report and Order at ¶ 9. One of the reasons that the Commission chose the benchmark approach was to provide a simple way of determining the reasonableness of rates while keeping administrative costs low. Cost-of-service regulation may undermine the benchmark and price cap regulatory approach, and is clearly contrary to Congress' clear direction that the Commission not impose common carrier-type cost-of-service regulation. Report and Order at ¶¶ 185-187. Local Governments are concerned that the adoption of liberal cost-of-service rules could undermine the benchmark method in two ways.

First, the primary goal of the benchmark and price cap method was to lower cable rates for most subscribers. The Commission noted in the Report and Order that "the initial rate regulations should produce substantial savings to consumers on an aggregate industry basis. These savings will result from rate reductions required from a broad segment of regulated cable operators that service most of the nation's cable subscribers." Report and Order at ¶ 9. (emphasis added). However, it has already become apparent that a significant number of the nation's cable subscribers may actually experience higher rates when the new rules

take effect on September 1, 1993.[4] Local Governments are concerned that implementation of cost-of-service rules that allow large numbers of cable operators to purport to justify rates higher than the benchmark would only exacerbate this problem. It is thus important for the Commission to ensure that the cost-of-service method remains a rarely-used "backstop" to the benchmark and price cap system rather than an easily-obtained alternative, as rates will only climb higher if cost-of-service showings are allowed to become commonplace.

Second, a major goal of the Commission's rate regulation scheme was to reduce the administrative burden on "cable operators, local franchising authorities, the Commission and consumers." Report and Order at ¶ 9. See also Section 623(b)(2)(A). Cost-of-service showings are at best a heavy administrative burden on all parties involved. A set of rules that allowed cable operators to insist on cost-of-service showings readily would mean that a significant portion of the resources of the Commission and of local franchising authorities would be expended on evaluating such showings. Therefore, it is important for the Commission to limit cost-of-service showings to cases involving unusual or unique circumstances.

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[4] See, e.g., "Cable TV Rates to Rise for Some Subscribers," Washington Post, August 18, 1993, at sec. A, p. 1, col. 6.

In addition, it also is important that, once a cable operator chooses either the benchmark or cost-of-service method for determining rates, it be required to use this same method in both the basic and cable programming service tier rate proceedings, if both proceedings occur within a reasonable time of each other. It is the Commission's intention that the same "reasonable" rate determination be made on both tiers, and it would undermine this intention if operators were given the unrestricted flexibility to decide that it would be more advantageous to submit a cost of service schedule in one proceeding while submitting a benchmark schedule in the other. Such "gaming" of the rate regulation rules by cable operators would be plainly inconsistent with the Congressional mandate to protect subscribers from unreasonable rate-setting practices.

B. Operators Should Be Required to Make a Significant Threshold Showing Before Being Permitted to Make a Cost-of-Service Showing.

For the reasons discussed above, the primary goal of the cost-of-service rules should be to ensure that cost-of-service showings act as a "backstop" to the benchmark and price cap method, so that operators are only allowed to invoke cost-of-service showings in extreme cases. The Commission seeks comment on whether it should establish procedural limits or bars on cost-of-service showings absent a demonstration of special circumstances or extraordinary costs. NPRM at ¶ 18. Local Governments

believe that a threshold showing of this type is absolutely necessary; without it, the Commission and franchising authorities across the nation would be inundated with hundreds or thousands of showings, and such showings could become the "norm" rather than the exception.

Such a threshold showing should include several elements. An operator seeking to justify rates higher than the benchmark should be required to show that these higher rates are necessitated by extraordinarily high and justifiable costs.[5] In order to test whether such high costs are justified, the costs in question should be compared with costs found in other similarly-situated systems. In addition, the recoverable costs must be for expenses that benefit all subscribers; cable subscribers should not be forced to "cross-subsidize" non-cable services or services that only a small number of subscribers may enjoy.[6]

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[5] If a cable operator attempts to demonstrate such a threshold showing in a cost-of-service submission to the Commission as part of the Commission's review of cable programming service tier rates, the franchising authority should have an opportunity to comment on the cable operator's submission.

[6] A prohibition on such "cross-subsidization" would be consistent with the Commission's goals in this proceeding. For example, the Commission recently stated that "[t]he Commission's goal is to make sure that rates are reasonable for <u>every</u> service tier and <u>every</u> piece of equipment offered to consumers . . . . It also wants to make sure that the subscribers who buy a particular service (or rent a particular piece of equipment) are the ones who actually

[Footnote continued on next page]

Operators should be permitted to make cost-of-service showings only where their allowable costs are extraordinarily high such that their revenue requirements substantially exceed revenues which would be generated through a proper allocation of the benchmark approach. The benchmark charts are intended to simulate rates for cable systems subject to effective competition, factoring in the reasonable costs of providing service and a reasonable profit. Rates based on the benchmark are presumptively reasonable. Report and Order at ¶ 187. Cable operators must not be allowed to circumvent this carefully structured system merely because their current rates are higher than the benchmark and they wish to continue charging such unreasonable rates. Congress implemented rate regulation under the 1992 Act because cable operators were utilizing their monopoly position to exact unjustifiably high rates.[7] It should be expected that most operators would have to lower their rates under the competition-based benchmark approach. Cost-of-service showings should be allowed only for the purpose of assisting operators for whom rates

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[Footnote continued from previous page]
pay for it -- that is, other subscribers should not be forced to pick up the bill for services or equipment they didn't buy." See "FCC Fact Sheet on Cable Rate Adjustments," FCC Public Notice, August 20, 1993, at 2-3 (emphasis in original).

[7] See S. Rep. No. 102-92, 102d Cong., 1st Sess. 9 (1991) ("Senate Report").

calculated under the benchmark would be confiscatory because the operators have special circumstances that result in extraordinarily high, justifiable costs.

An operator should not be permitted to recover high costs in a cost-of-service showing unless such costs are justified in light of the unique circumstances present in the system. The determination of whether such costs are justified should be made with reference to costs experienced by other similarly-situated systems. By requiring the operator to compare its costs with the costs incurred by systems that have, among other things, similar numbers of subscribers and similar service offerings, the Commission would ensure that operators that are inefficient or that incur costs that are not otherwise justified would not have an opportunity to use these costs as a means of justifying rates above the benchmark. Otherwise, cable operators would have little or no incentive to control their costs and charge reasonable rates.

Finally, a cable operator should be required to show that the extraordinary costs benefit all of the system's subscribers. This requirement is necessary to prevent operators from seeking to justify regulated rates above the benchmark that are based on expenditures for non-cable services (e.g., telephone services) or unregulated services (e.g., provision of specialized or pay-per-view programing). Operators should not be allowed to pass such

expenditures on to subscribers who may never enjoy the benefits of such expenditures.

For example, expenditures on upgrades should only be recoverable in cost-of-service showings if they benefit all subscribers. A system upgrade that improves service on the basic tier might be recoverable if such costs are not recoverable out of revenues permitted under the benchmark rate. However, it should not be possible for operators to justify higher basic tier rates for costs incurred in upgrading the system in a way that benefits only premium, per-channel or pay-per-view subscribers.

C. Cost Standards

The Commission asks a number of questions relating to the costs that an operator should be permitted to recover under a cost-of-service showing. Local Governments believe that certain kinds of costs -- such as excess acquisition costs and costs unrelated to the provision of cable service -- should be excluded from recoverable costs. In addition, the manner in which allowable costs are allocated among commonly-owned or controlled systems is critical; allowable costs should be allocated on a franchise-by-franchise basis wherever possible.

1. Costs Should be Allocated on a Franchise-by-Franchise Basis Wherever Possible.

The Commission asks whether it should adopt new or supplemental rules to govern allocation of costs in

addition to the cost allocation rules adopted in the Report and Order. NPRM at ¶ 59. The rules promulgated in the Report and Order generally allocate costs at the local franchise level. See Report and Order at ¶ 559. Local Governments endorse that approach and believe that any additional cost allocation rules the Commission might adopt should allocate costs at the local level.

Local Governments believe that, wherever possible, costs should be identified on a franchise-by-franchise basis. The primary thrust of the cost-of-service rules is to provide a means by which an operator can recover extraordinary system costs caused by special circumstances unique to that franchise area that are not covered by the benchmark rate. Only by identifying costs on a franchise-by-franchise basis can the Commission ensure that an MSO will not be able to shift costs from one system to another; otherwise, such "gaming" of the rules could mean that subscribers of a system in one franchise area end up paying higher rates without receiving any of the attendant benefits of additional expenditures in order to cover the higher costs of a system in another franchise area. Further, a franchising authority can more easily verify costs when they are identified individually by system.

Of course, there are certain costs that are incurred by an MSO that are truly nationwide or regional costs that cannot reasonably be identified as pertaining to individual

franchise areas. Such costs may include, for example, the costs of obtaining programming, company-wide administrative costs or company-wide advertising costs. In such cases, these truly MSO-wide costs should be allocated among franchise areas based on each franchise area's pro rata share of the MSO's total number of subscribers. Such allocation will help prevent MSOs from "weighting" certain franchise areas with an inordinate percentage of the MSO-wide costs.

2. The Commission Should Adopt Special Rules to Deal with Affiliate Transactions.

Local Governments strongly agree with the Commission's tentative conclusion that it should adopt special rules to cover costs incurred by systems in transactions with affiliated companies. Such rules are necessary to ensure that affiliated companies are not able to artificially inflate transaction costs for the purposes of showing increased costs. This is especially true in contracts for the provision of programming, due to the growing number of vertically-integrated MSOs. Local Governments propose that, with respect to affiliate transactions, the Commission adopt rules that allow recovery only of those costs that would have been incurred if the transaction had been an arms-length transaction among unrelated parties.

3. Excess Acquisition Costs Should Be Excluded.

Local Governments agree with the Commission's tentative conclusion that excess acquisition costs should be excluded from the rate base. NPRM at ¶ 40. Excess acquisition costs are in essence a "monopoly rent"; the increased cost of the system over the value of the tangible assets is the result of the monopoly position that nearly every cable system enjoys. There is no reason whatsoever for cable subscribers to pay higher rates to allow the operator to recover such excessive costs. This is especially true in light of the fact that a system's subscribers enjoy no benefit from the excess costs paid for the system, since such excess costs in no way contribute to the tangible asset value of the system or to the improvement of service. Moreover, Congress intended for the rate regulations adopted by the Commission to eliminate this monopoly component of cable rates. See Section 623(b)(1).

D. Streamlining Alternatives

The Commission seeks comment on a number of alternatives that would streamline the establishment of cost-based rates by cable operators. NPRM at ¶ 70. Local Governments support the Commission's goal of reducing the administrative burden on all parties that traditional cost-of-service showings would entail. However, the Commission should not adopt rules that would undermine the benchmark

and price cap system in the name of simplicity. The Local Governments support the proposal to establish, in certain circumstances, an abbreviated cost-of-service showings for significant prospective capital expenditures. However, Local Governments do not support this streamlining alternative in the form currently proposed by the Commission. Also, Local Governments believe that several other alternatives proposed by the Commission -- national averaging of costs and special rules for small systems -- are not warranted.

1. Significant Prospective Capital Expenditures

The Commission proposes to establish an abbreviated cost-of-service showing for significant prospective capital expenditures used to improve the quality of service or to provide additional services. NPRM at ¶ 75. While Local Governments support the objective of such an approach, they believe that it requires significant further study to ensure that it is not abused, as the approach proposed in the NPRM has a number of pitfalls that render it unworkable. The most serious difficulty is that it does not take into account whether the operator is unable to recover the costs of the upgrade through rates determined under the benchmark because the operator is inefficient or has frivolous or other unjustified expenses. Thus, Local Governments do not support this alternative in its present form.

2. National Cost Averaging

Local Governments oppose the Commission's proposal to permit cable operators to justify rates based on the average cost of providing service by cable systems nationwide. NPRM at ¶ 74. The primary reason for allowing cost-of-service showings is to allow an operator to justify rates based on extraordinary costs unique to that system. A system in which costs were averaged nationally would fail to take such local costs into account. Further, cost-of-service showings are designed to permit individual operators to obtain relief from a national rate average, i.e., the benchmark. It would not address the problem if an operator with extraordinary individual costs were faced with yet another national average that was below the operator's allowable costs.[8]

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[8] The Commission also has proposed that rates be considered reasonable if they are no higher than they were in 1986, after adjustments for inflation and a productivity offset. NPRM at ¶ 71. Local Governments oppose this alternative. Most cable operators have extensively retiered their systems since 1986, and have added channels and changed programming. Thus, services and rates charged in 1986 may not be comparable to current service and rates, and may not reflect current service offerings. Further, prior to 1986, several states, such as California and Massachusetts, prohibited franchising authorities from regulating rates. Thus, there were no restrictions on the ability of cable operators in those states to charge monopolistic rates. Therefore, since 1986 rates were not necessarily reasonable, it does not make sense to adjust 1986 rates to determine whether current rates are reasonable.

3. Small System Exception

The Commission solicits comment on whether it should adopt modifications to the cost-of-service rules that will reduce administrative burdens on small systems making cost-of-service showings. Local Governments believe that such special rules are not warranted. While Local Governments support procedures that will reduce the administrative burden on all parties, they do not believe that small systems should be singled out for preferential treatment. First, the difficulties facing many small systems have been greatly exaggerated. Many "small" systems -- those with 1,000 subscribers or less -- are often systems that earn high rates of return. In addition, such systems are often parts of large MSOs. There is no reason that subscribers of small systems should have any less protection from unreasonable rates than subscribers of large systems.

III. CONCLUSION

The Commission should establish rules governing cost-of-service showings that ensure that the benchmark and price cap method remains the primary method of regulating rates. Operators should be permitted to make cost-of-service showings only upon demonstrating that the system's

costs are extraordinarily high based on special circumstances.

Respectfully submitted,

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